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DESIGN ELEMENTS OF A BONUS-BID AUCTION - ADDENDUM

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This addendum provides a brief explanation of the auction design criteria and design elements presented in the April 26, 1988, paper entitled "Design Elements of a Bonus-Bid Auction."

DESIGN CRITERIA

Criterion 1 - Increases Bidding Competition

Strong competition among buyers allows a seller to be more confident of receiving a good price for the item auctioned.

Criterion 2 - Results in High Bids

A seller benefits from bids that are as high as possible, i.e., which approach the full monetary value of the item to the buyer who values the item the highest.

Criterion 3 - Raises Total Receipts

A seller may receive other monetary benefits, besides the high bid, from an auction. For example, the seller of a lease will later receive payments from the lease purchaser in the form of lease rentals and royalties. By exercising care in setting the rental and royalty terms to be neither too high nor too low, the seller can increase total receipts.

Criterion 4 - Increases the Value of the Item to the Buyer

The higher the value of the offerings in an auction, the higher the likely bids. The net return to the seller can be improved by identifying and adopting terms or conditions of the sale that significantly add to the value of the offerings to buyers, but cost the seller little. The seller can also benefit by releasing, prior to the sale, favorable information about the value of the items to be offered.

Criterion 5 - Has Low Administrative Costs

Alternative auction processes differ in their administrative costs, including sale preparation, overhead, and participation costs. Lowering such costs generally benefits the seller. The lower the buyers'

administrative costs, the greater the number of buyers likely to be at the sale, with attendant benefits to the seller. And the lower the seller's administrative costs, the greater the seller's net profit from the sale.

Criterion 6 - Works Well in a Wide Variety of Circumstances

Some auction processes tend to work at least adequately well in almost all sale situations. Other auction processes do not work as well, in general, but can be superior in specific situations. Where these specific situations can be identified, the seller can benefit from using a specialized auction process; however, if the sale situation is uncertain or may vary, a more robust auction process would be a safer choice.

Criterion 7 - Is Simple and Understandable

The risk of an administrative error by the seller is reduced when the auction process is simple. Explaining the auction process is also easier. A simple process may also bring in more bidders.

Criterion 8 - Aids Bid Acceptance/Rejection Decisions

In some auction processes, the seller retains the right to reject those offers deemed inadequate. The seller relies on pre-sale appraisals of the items offered and on the degree of bidding competition evidenced for each item to make these decisions. The seller's decision to accept or reject a high bid for an item may also be based on the high bids submitted for similar items at the sale. Accordingly, it is helpful to the seller to have an auction process that clearly reveals the extent of bidding competition for each item and allows the seller to examine all high bids tendered at the sale before making any bid-acceptance decisions.

Criterion 9 - Sells the Item Rapidly

Some auction processes are more likely than others to result in a completed sale. In general, failure to complete a sale imposes a cost on the seller, if only the administrative cost of re-offering the item not sold. Where the item offered is a lease, failure to sell may result in a delay in, or ultimate loss of, lease rental and royalty payments.

Criterion 10 - Allocates Item to Highest and Best User

If the items sold are leases and they are auctioned directly to the best users, this may result in more rapid lease development and earlier and greater royalties for the seller.

DESIGN ELEMENTS

Element 1 - Method of Bid Entry

The seller may accept bids in a number of ways. Common approaches include sealed bidding, progressive oral bidding, and the Dutch descending price auction where the seller starts by announcing a high asking price and gradually reduces the price until a bid is tendered. The seller may also choose a combination of methods, such as sealed bidding followed by progressive oral bidding.

Element 2 - Price the High Bidder Must Pay

The high bidder who wins an auction commonly pays the high bid offered. In Vickrey sealed bid auctions, however, the high bidder pays the second highest sealed bid (the highest losing bid).

Element 3 - Duration of Offering

The amount of time the seller gives to potential bidders to become aware of the offering, to gather information about the value of the item, and to prepare a bid can significantly affect the bids offered. Increased lead time generally increases participation, bidder information, and bids.

Element 4 - Payment or Charge to Participants

The seller may charge an entrance or participation fee in order to discourage frivolous participation in the auction. The seller may also make some form of a participation payment to pre-selected desirable bidders in order to induce them to participate. The seller may also offer to pay certain losing bidders, e.g., the second highest bidder in a sealed bid auction, a consolation fee in order to encourage greater competition.

Element 5 - Bidder Qualifications

The seller may set certain financial qualifications on bidders in order to ensure that winning bidders can pay

for their winnings. In some auctions, only bidders with special qualifications, such as small businesses or U.S. licensed corporations, are allowed to participate.

*Element 6 - Limitations Placed by Bidders
on Expenditures*

In some sealed bid auctions of multiple items, the seller allows each bidder to specify a limit either on the number of items they wish to buy or on the total amount they wish to spend at the sale. Each bidder submits a winning or spending limit along with their sealed bids. The seller then opens the bids for each item in an item order specified before the sale and identifies the high bid and winner of each item. Once a bidder reaches his or her winning or spending limit, all of that bidder's bids for the remaining items in the sale are canceled.

*Element 7 - Limitations Placed by Seller on Number
of Items Sold*

In some sealed bid auctions of multiple similar items, the seller may choose to offer more items than the seller will allow to be sold. The seller may set a sales limit in terms of the number of items or a total dollar amount. The seller may set the sales limit before or after the sale and may or may not announce the specific limit before the sale. Only those items getting the highest bids would be sold.

Element 8 - Order of Offering Items for Sale

In an oral auction, the seller offers items one at a time. The order in which the items are offered can influence which items get sold and what prices are obtained. In a sealed bid auction, the seller usually takes bids for all items simultaneously and the item order in which the bids are opened does not matter. However, sealed bids could be taken then opened for each item one at a time, much like an oral auction. In such a case, the order in which the items were offered would matter.

*Element 9 - Whether and How the Seller Uses
Own Evaluation or Data
to Influence the Price*

In some auctions, the seller simply accepts the high bids that result from the auction. In other auctions, the seller reviews the high bids based on the seller's own evaluations of the items' worth, and rejects bids that are too low. The seller may also provide these

evaluations or other favorable information about the items to potential bidders before the sale in an attempt to positively affect the bidding.

Element 10 - Method of Payment

The seller may be able to increase bidder participation and high bids by being willing to take payment over time, rather than to require immediate cash payment in full.

*Element 11 - Information Provided by Seller
After Sale*

Certain information, if disclosed by the seller after the sale, could affect the bidding at future sales. This information includes the names of the bidders, the bids entered, and the seller's pre-sale evaluations of the items sold or not sold.

Element 12 - Timing of Re-offering

The seller's policy for when items not sold at a sale would be re-offered could affect the bidding at the sale. This may be of considerable importance where the seller has a policy of rejecting bids deemed inadequate.